

BROITMAN DECLARATION EXHIBIT 13



2005 Annual Report
AT&T Inc.



AT&T Inc. Financial Review 2005

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SELECTED FINANCIAL AND OPERATING DATA

Dollars in millions except per share amounts

At December 31 or for the year ended:	2005	2004	2003	2002	2001
Financial Data^{1,2}					
Operating revenues	\$ 43,862	\$ 40,787	\$ 40,498	\$ 42,821	\$ 45,381
Operating expenses	\$ 37,694	\$ 34,886	\$ 34,214	\$ 34,383	\$ 35,085
Operating income	\$ 6,168	\$ 5,901	\$ 6,284	\$ 8,438	\$ 10,296
Interest expense	\$ 1,456	\$ 1,023	\$ 1,191	\$ 1,382	\$ 1,599
Equity in net income of affiliates	\$ 609	\$ 873	\$ 1,253	\$ 1,921	\$ 1,595
Other income (expense) – net	\$ 14	\$ 922	\$ 1,767	\$ 733	\$ (236)
Income taxes	\$ 932	\$ 2,186	\$ 2,857	\$ 2,910	\$ 3,858
Income from continuing operations	\$ 4,786	\$ 4,979	\$ 5,859	\$ 7,361	\$ 6,881
Income from discontinued operations, net of tax³	\$ —	\$ 908	\$ 112	\$ 112	\$ 127
Income before extraordinary item and cumulative effect of accounting changes	\$ 4,786	\$ 5,887	\$ 5,971	\$ 7,473	\$ 7,008
Net income⁴	\$ 4,786	\$ 5,887	\$ 8,505	\$ 5,653	\$ 7,008
Earnings per common share:					
Income from continuing operations	\$ 1.42	\$ 1.50	\$ 1.77	\$ 2.21	\$ 2.04
Income before extraordinary item and cumulative effect of accounting changes	\$ 1.42	\$ 1.78	\$ 1.80	\$ 2.24	\$ 2.08
Net income⁴	\$ 1.42	\$ 1.78	\$ 2.56	\$ 1.70	\$ 2.08
Earnings per common share – assuming dilution:					
Income from continuing operations	\$ 1.42	\$ 1.50	\$ 1.76	\$ 2.20	\$ 2.03
Income before extraordinary item and cumulative effect of accounting changes	\$ 1.42	\$ 1.77	\$ 1.80	\$ 2.23	\$ 2.07
Net income⁴	\$ 1.42	\$ 1.77	\$ 2.56	\$ 1.69	\$ 2.07
Total assets	\$145,632	\$110,265	\$102,016	\$ 95,170	\$ 96,416
Long-term debt	\$ 26,115	\$ 21,231	\$ 16,097	\$ 18,578	\$ 17,153
Construction and capital expenditures	\$ 5,576	\$ 5,099	\$ 5,219	\$ 6,808	\$ 11,189
Dividends declared per common share ⁵	\$ 1.30	\$ 1.26	\$ 1.41	\$ 1.08	\$ 1.025
Book value per common share	\$ 14.11	\$ 12.27	\$ 11.57	\$ 10.01	\$ 9.82
Ratio of earnings to fixed charges	4.11	6.32	6.55	6.20	5.83
Debt ratio	35.9%	40.0%	32.0%	39.9%	44.3%
Weighted-average common shares outstanding (000,000)	3,368	3,310	3,318	3,330	3,366
Weighted-average common shares outstanding with dilution (000,000)	3,379	3,322	3,329	3,348	3,396
End of period common shares outstanding (000,000)	3,877	3,301	3,305	3,318	3,354
Operating Data					
Network access lines in service (000) ⁶	49,413	52,356	54,683	57,083	59,532
DSL lines in service (000) ⁶	6,921	5,104	3,515	2,199	1,333
Wireless customers (000) – Cingular ⁷	54,144	49,132	24,027	21,925	21,596
Number of employees ²	189,950	162,700	168,950	175,980	193,420

¹Amounts in the above table have been prepared in accordance with U.S. generally accepted accounting principles.²Amounts in 2005 reflect results from AT&T Corp. for the 43 days following the November 18, 2005 acquisition.³Our financial statements for all periods presented reflect results from our sold directory advertising business in Illinois and northwest Indiana as discontinued operations. The operational results and the gain associated with the sale of that business are presented in "Income from discontinued operations, net of tax."⁴Amounts include the following extraordinary item and cumulative effect of accounting changes: 2003, extraordinary loss of \$7 related to the adoption of Financial Accounting Standards Board Interpretation No. 46 "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51" and the cumulative effect of accounting changes of \$2,541, which includes a \$3,677 benefit related to the adoption of Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" and a \$1,136 charge related to the January 1, 2003 change in the method in which we recognize revenues and expenses related to publishing directories from the "issue basis" method to the "amortization" method; 2002, charges related to a January 1, 2002 adoption of Statement of Financial Accounting Standards No. 142, "Goodwill and Other Intangible Assets."⁵Dividends declared by AT&T's Board of Directors reflect the following: 2003, includes three additional dividends totaling \$0.25 per share above our regular quarterly dividend payout.⁶The number presented reflects wireline segment lines in service.⁷The number presented represents 100% of Cingular Wireless' (Cingular) cellular/PCS customers. The 2004 number includes customers from the acquisition of AT&T Wireless Services Inc. Cingular is a joint venture in which we own 60% and is accounted for under the equity method.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Dollars in millions except per share amounts

For ease of reading, AT&T Inc. is referred to as "we," "AT&T," or the "Company" throughout this document and the names of the particular subsidiaries and affiliates providing the services have been omitted. Prior to the November 18, 2005 acquisition of AT&T Corp. (ATTC), we were known as SBC Communications Inc. (SBC). AT&T is a holding company; AT&T does not provide communications services, rather, its subsidiaries and affiliates operate in the communications services industry both domestically and internationally providing wireline and wireless telecommunications services and equipment as well as directory advertising and publishing services. You should read this discussion in conjunction with the consolidated financial statements and accompanying notes. A reference to a "Note" in this section refers to the accompanying Notes to Consolidated Financial Statements. In our tables throughout this section, percentage increases and decreases that equal or exceed 100% are not considered meaningful and are denoted with a dash.

RESULTS OF OPERATIONS
Consolidated Results

Our financial results are summarized in the table below. We then discuss factors affecting our overall results for the past three years. These factors are discussed in more detail in our segment results. We also discuss our expected revenue and expense trends for 2006 in the "Operating Environment and Trends of the Business" section.

We completed our acquisition of ATTC on November 18, 2005. In accordance with U.S. generally accepted accounting principles (GAAP), we included results from ATTC in our consolidated results for the remaining 43 days of 2005 (see Note 2). Operating results for ATTC prior to our acquisition are not discussed. Also in accordance with GAAP, our financial statements reflect results from our sold directory advertising business in Illinois and northwest Indiana as discontinued operations (see Note 17). The operational results and the gain associated with the sale of that business are presented in the "Income From Discontinued Operations, net of tax" line item below and on the Consolidated Statements of Income.

	2005	2004	2003	Percent Change	
				2005 vs. 2004	2004 vs. 2003
Operating revenues	\$43,862	\$40,787	\$40,498	7.5%	0.7%
Operating expenses	37,694	34,886	34,214	8.0	2.0
Operating income	6,168	5,901	6,284	4.5	(6.1)
Income before income taxes	5,718	7,165	8,716	(20.2)	(17.8)
Income from continuing operations	4,786	4,979	5,859	(3.9)	(15.0)
Income from discontinued operations, net of tax	—	908	112	—	—
Income before extraordinary item and cumulative effect of accounting changes	4,786	5,887	5,971	(18.7)	(1.4)
Extraordinary item ¹	—	—	(7)	—	—
Cumulative effect of accounting changes ²	—	—	2,541	—	—
Net income	4,786	5,887	8,505	(18.7)	(30.8)
Diluted earnings per share	1.42	1.77	2.56	(19.8)	(30.9)

¹2003 includes an extraordinary loss on our real estate leases related to the adoption of Financial Accounting Standards Board (FASB) Interpretation No. 46 "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51" (FIN 46).

²2003 includes cumulative effect of accounting changes of \$2,541: a \$3,677 benefit related to the adoption of Statement of Financial Accounting Standards No. 143, "Accounting for Asset Retirement Obligations" (FAS 143); and a \$1,136 charge related to the January 1, 2003 change in the method in which we recognize revenues and expenses related to publishing directories from the "issue basis" method to the "amortization" method.

Overview

Operating income Our operating income increased \$267, or 4.5%, in 2005 and decreased \$383, or 6.1% in 2004. Our operating income margin decreased from 15.5% in 2003 to 14.5% in 2004 and 14.1% in 2005. Approximately \$118 of the \$267 increase in operating income during 2005 was due to our AT&T Corp. segment results. Our increased operating income in 2005 was driven by further growth in Data and Long-distance voice revenues, reflecting increased volumes, our continued emphasis on our bundling strategy and the addition of new business customers, partially offset by a decline in our Voice revenue as we continue to experience increasing competition. The operating margin decrease in 2005 reflects additional operating expenses associated with a charge to terminate an agreement with WilTel Communications (WilTel) and merger-related charges. The operating income and associated margin decrease in 2004

was primarily due to increased cost of sales and expenses from strike preparation and labor settlements. These expense increases were larger than the increase in revenue, which was attributable to growth in Long-distance voice and Data revenues partially offset by the decline in Voice revenue caused by a decline in retail access lines.

Retail access lines continued to decline due to increased competition, as customers disconnected both primary and additional lines and began using wireless and, to a lesser extent, Voice over Internet Protocol (VoIP) technology and cable instead of phone lines for voice and data. This was also a contributing factor in the year-ago period. Retail access lines also declined for both periods due to customers disconnecting their additional lines when purchasing our broadband internet-access (DSL) services. While we lose some revenue when a wireline customer shifts from one of our retail primary lines to a competitor that relies on a

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

Dollars in millions except per share amounts

resale or commercial UNE-P replacements (commercial agreements with various Unbundled Network Element-Platform or "UNE-P" providers) (i.e., one of our wholesale customers), we lose all revenue when a wireline customer shifts to an alternative technology such as cable, wireless or VoIP or a facilities-based competitor. However, when a customer signs up for Cingular Wireless (Cingular) service, our net income impact of the lost revenue is lessened because we own a 60% economic interest in Cingular (see Note 6). Increasing use of alternative technologies and facilities-based competition will continue to pressure our operating margins. Although retail access line losses have continued, the trend has slowed, reflecting in part our ability to offer retail nationwide long-distance service as well as offerings combining multiple services for one fixed price (bundles).

The decline in Voice revenue for both 2005 and 2004 also reflects decreasing wholesale revenues from lines provided under UNE-P rules (which include commercial UNE-P replacements), reflecting changes in UNE-P rules over the past two years. During the 12-month transition period for the elimination of the UNE-P requirements (which ends in March 2006), we have been experiencing a decrease in the number of UNE-P lines as competitors move to alternate arrangements to serve their customers or their customers choose an alternative technology. Since this transition period started, our wholesale customers representing a majority of our UNE-P lines have signed commercial agreements with us. For the remaining UNE-P lines, we believe, based on marketing research, that customers are primarily switching from their UNE-P provider to alternative technology or facilities-based competitors (competitors with their own networks) as opposed to returning as our retail customers. For additional details on UNE-P, see "Triennial Review Remand Order" discussed in "Regulatory Developments."

Operating revenues Our operating revenues increased \$3,075, or 7.5%, in 2005 and \$289, or 0.7%, in 2004. Operating revenues from our AT&T Corp. segment were \$2,887. Our significant revenue impacts are listed below and discussed in greater detail in our "Segment Results" section.

- Data revenues increased \$1,980 in 2005 and \$834 in 2004, primarily driven by additional revenues of \$1,129 from ATTC in 2005 and continued growth in DSL for both periods.
- Long-distance voice revenues increased \$1,667 in 2005 and \$736 in 2004, mostly attributable to ATTC revenues of \$1,208 in 2005 and increased bundled sales of combined long-distance and local calling fixed-fee offerings in both periods.

These increases in Data and Long-distance voice revenues were partially offset by declines of \$759 in 2005 and \$1,190 in 2004 in Voice revenues, primarily resulting from the loss of retail and wholesale access lines and lower prices due to increased competition. The decline in our 2005 Voice revenues was slightly offset by the inclusion of ATTC Voice revenues for 43 days. Our 2005 Voice revenue decline also reflects an increase of \$60 in 2004 related to regulatory and other matters, including the California Public Utilities Commission's (CPUC) September 2004 decision on UNE-P rates (see "State UNE Pricing Proceedings" discussed in "Regulatory Developments").

Operating expenses Our operating expenses increased \$2,808, or 8.0%, in 2005 and \$672, or 2.0%, in 2004. Our significant expense changes are listed below and discussed in greater detail in our "Segment Results" sections.

2005

- Following our acquisition of ATTC, we included approximately \$2,769 of its operating expenses for the 43-day period ended December 31, 2005. This included depreciation and amortization expense of \$414, of which \$191 was associated with acquired intangible assets.
- Merger-related asset impairments and severance accruals increased operating expense approximately \$349 and \$283, respectively.
- Costs primarily associated with wage increases increased operating expense approximately \$338.
- A charge to terminate existing agreements with WilTel increased operating expenses approximately \$236.
- Traffic compensation in our wireline segment (fees paid for access to another carrier's network), primarily due to higher call volumes generated by growth in our long-distance business, increased operating expenses approximately \$330. Included in ATTC's operating expenses was traffic compensation expense, a significant expense for our AT&T Corp. segment, of approximately \$1,102 for the 43 days.
- Costs associated with equipment sales and related network integration services reflecting sales in the large-business market, and prior to the amendment discussed in "Other Business Matters," our co-branded AT&T | DISH Network satellite TV service, which had more total customers than in the prior year, increased operating expenses approximately \$195.

Partially offsetting the 2005 increase were reduced expenses of approximately \$590 associated with reduced workforce levels and lower depreciation expenses of approximately \$333 in the wireline segment as well as the 2004 charges of approximately \$263 associated with strike preparation and labor contract settlements. Expenses also reflect an increase of approximately \$49 for net pension and postretirement cost, a decrease of approximately \$96 associated with changes in retiree out-of-region phone concessions in 2005 and \$90 due to a charge resulting from an amendment to our management pension plan in 2004 (see Note 10).

2004

- Costs associated with our growth initiatives, including increased equipment sales and services to upgrade and integrate large-business customer network components (network integration services), increased operating expenses approximately \$603.
- Net impacts from strike preparation and labor settlements increased operating expenses approximately \$263.
- Costs associated with traffic compensation primarily due to higher call volumes generated by growth in our long-distance business, increased operating expenses approximately \$122.
- A fourth-quarter 2004 amendment to our management pension plan resulted in a charge which increased operating expenses approximately \$90.

The 2004 increases were partially offset by decreased combined pension and postretirement cost of approximately \$548. During 2004, the majority of nonmanagement retirees were informed of medical coverage changes that affected cost sharing, which became effective January 1, 2005. These changes reduced our postemployment cost approximately \$440 in 2004. Also contributing to the decreased combined pension and postretirement costs were better-than-expected asset returns in 2003, which decreased expense \$322, and our accounting for the Medicare Prescription Drug, Improvement and Modernization Act of 2003 (Medicare Act), which decreased expense \$255. Partially offsetting those expense decreases were (1) higher-than-expected medical and prescription drug claims, increasing expense approximately \$156; (2) the reduction of the discount rates used to calculate service and interest cost from 6.75% to 6.25%, in response to lower corporate bond interest rates, increasing expense \$141; and (3) our 2004 medical cost trend rate increase, increasing expense \$83. The trend rate increased because we decided to extend our 2003 medical cost rates into 2004 due to rising claim costs while maintaining our assumption that the rate will trend to a final expected annual increase of 5.0% in 2009 for all retirees.

Interest expense increased \$433, or 42.3%, in 2005 and decreased \$168, or 14.1%, in 2004. The increase in 2005 was primarily due to issuing additional debt in the fourth quarter of 2004, thus accruing interest expense for a full 12 months of 2005 in comparison to less than three months of 2004. In 2004 we issued debt totaling approximately \$8,750 to finance our portion of Cingular's purchase price for AT&T Wireless Services Inc. (AT&T Wireless). In addition, we recorded approximately \$63 of interest expense related to ATC's outstanding debt. We expect our future interest expense to increase as a result of including ATC's outstanding debt in our consolidated financial statements. However, this increase will be partially offset due to our redemption, prior to maturity, of approximately \$1,559 of debt in 2005.

The decrease in 2004 was primarily due to lower debt levels caused by the early redemption of approximately \$1,743 of our bonds in 2003.

Interest income decreased \$109, or 22.2%, in 2005 and \$111, or 18.4%, in 2004. The decrease in 2005 was primarily due to lower investment balances during 2005 as investments held for the majority of 2004 were liquidated and used to fund our portion of Cingular's purchase price for AT&T Wireless, and less income earned on our advances to Cingular resulting from payments during 2005 on a portion of outstanding advances due to us. The decrease in 2004 was primarily related to the early settlement in 2003 of our notes receivable associated with the 2002 sale of our investment in Bell Canada Holdings Inc. to BCE, Inc. (BCE). This settlement included approximately \$37 of prepaid interest. Also contributing to the decrease in 2004 was our 2003 renegotiation of the interest rates, from 7.5% to 6.0%, charged on our advances to Cingular.

Equity in net income of affiliates decreased \$264, or 30.2%, in 2005 and \$380, or 30.3%, in 2004. The 2005 decrease was due to lower results from our international holdings of approximately \$417 (largely attributable to

gains that occurred in 2004, and foregone equity income from the disposition of investments), partially offset by an increase of approximately \$170 in our proportionate share of Cingular's results (including a charge of \$105 that Cingular recorded in 2004 resulting from the correction of an error related to its lease accounting practices).

The 2004 results included increased income from our international holdings of approximately \$206, primarily related to TDC A/S's (TDC) gain on the sale of its interest in Belgacom S.A. (Belgacom) (see Note 2), offset by a decline of \$583 in our proportionate share of Cingular's results.

We account for our 60% economic interest in Cingular under the equity method of accounting and therefore include our proportionate share of Cingular's results in our "Equity in net income of affiliates" line item in our Consolidated Statements of Income. Cingular's operating results are discussed in detail in the "Cingular Segment Results" section and results from our international holdings are discussed in detail in "International Segment Results." Our accounting for Cingular is described in more detail in Note 6.

Other income (expense) – net We had other income of \$14 in 2005, \$922 in 2004 and \$1,767 in 2003. Results for 2005 primarily included a gain of approximately \$108 on the sales of shares of Amdocs Limited (Amdocs), SpectraSite, Inc. (SpectraSite) and Yahoo! Inc. (Yahoo), a gain of \$24 from the sale of a lease partnership and gains of approximately \$24 related to the transfer of wireless properties to Cingular. These gains were partially offset by other expenses of \$126 to reflect an increase in value of a third-party minority holder's interest in an AT&T subsidiary's preferred stock and expenses of \$26 due to call premiums on early debt retirement.

Results for 2004 primarily included a gain of approximately \$832 on the sale of our investment in Belgacom, gains of \$270 on the sales of shares of Amdocs and Yahoo and a gain of \$57 on the sales of shares of Teléfonos de México, S.A. de C.V. (Telmex) and América Móvil S.A. de C.V. (América Móvil). These 2004 gains were partially offset by 2004 losses of approximately \$138 on the sale of all of our shares of TDC, \$82 on the sale of all of our shares of Telkom S.A. Limited (Telkom) and \$21 on the sale of another investment.

Results for 2003 included gains of approximately \$1,574 on the sale of our interest in Cegetel S.A. and gains of \$201 on the sales of Yahoo and BCE shares, partially offset by a loss of \$50 due to call premiums on early debt retirement.

Income taxes decreased \$1,254, or 57.4%, in 2005 and \$671, or 23.5%, in 2004. Our effective tax rate in 2005 was 16.3% compared to 30.5% in 2004. The decrease in income taxes and our effective tax rate in 2005 compared to 2004 was due primarily to our agreement in December 2005 with the Internal Revenue Service (IRS) to settle certain claims principally related to the utilization of capital losses and tax credits for tax years 1997-1999, by certain SBC entities. The settlement resulted in our recognition of \$902 of reduced income tax expense in 2005. The decrease in income tax expense in 2004 compared to 2003 was primarily due to lower income before income tax in 2004 than in 2003. Our effective tax rate in 2003 was 32.8%. The decrease in effective tax rate in 2004 compared to 2003 is

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

Dollars in millions except per share amounts

primarily a result of the accrual related to the nontaxable Medicare Act reimbursement accruals, tax settlements and impacts from our foreign operations. (See Note 9)

Income from discontinued operations was \$908 in 2004 and \$112 in 2003 and represents results from the directory advertising business in Illinois and northwest Indiana that we sold in 2004. The increase of \$796 in 2004 consisted of the portion of our sold directory operations and includes the gain on the sale of these operations of \$827, net of tax (see Note 17). Operating results for 2004 include only eight months of activity prior to the sale, resulting in lower revenues and expenses than in 2003. Revenues from discontinued operations decreased \$170, or 35.3%, and expenses decreased \$116, or 39.3%, in 2004.

Extraordinary item in 2003 consisted of an extraordinary loss of \$7, net of taxes of \$4, related to consolidation of real estate leases under FIN 46 (see Note 1).

Cumulative effect of accounting changes Effective January 1, 2003, we changed our method of recognizing revenues and expenses related to publishing directories from the "issue basis" to the "amortization method." Our directory accounting change resulted in a noncash charge of \$1,136, net of an income tax benefit of \$714, recorded as a cumulative effect of accounting change on the Consolidated Statement of Income as of January 1, 2003. (See Note 1)

On January 1, 2003, we adopted FAS 143, which changed the way we depreciate certain types of our property, plant and equipment. The noncash gain resulting from adoption was \$3,677, net of deferred taxes of \$2,249, recorded as a cumulative effect of accounting change on the Consolidated Statement of Income as of January 1, 2003. (See Note 1)

Segment Results

Our segments represent strategic business units that offer different products and services and are managed accordingly. Due to the proximity of our acquisition of ATTC to year end, we have reported those results in the AT&T Corp. segment even though there may be some overlap in the products and service provided by that segment and our wireline segment. Our operating segment results presented in Note 4 and discussed below for each segment follow our internal management reporting. We analyze our various operating segments based on segment income. Interest expense, interest income, other income (expense) — net and income tax expense are managed only on a total company basis and are, accordingly, reflected only in consolidated results. Therefore, these items are not included in the calculation of each segment's percentage of our total segment income. Each segment's percentage of total segment operating revenue calculation is derived from our segment results table in Note 4 and reflects amounts before eliminations. We have six reportable segments that reflect the current management of our business: (1) wireline, (2) AT&T Corp., (3) Cingular, (4) directory, (5) international, and (6) other.

The **wireline segment** accounted for approximately 47% of our 2005 total segment operating revenues as compared to 61% in 2004 and 55% of our 2005 total segment income as compared to 52% in 2004. This segment consists of our traditional SBC wireline subsidiaries and operates as both a

retail and wholesale seller of communications services providing landline telecommunications services, including local and long-distance voice, switched access, data and messaging services and satellite television services through our agreement with EchoStar Communications Corp. (EchoStar).

The **AT&T Corp. segment** accounted for approximately 4% of our 2005 total segment operating revenues and 2% of our 2005 total segment income. This segment reflects 100% of the results of ATTC for the 43 days following the November 18, 2005 acquisition. ATTC operates as both a retail and wholesale seller of communications services, primarily providing long-distance and local voice, data services and managed networking to business customers. ATTC also provides local and long-distance voice and data services to consumers.

The **Cingular segment** accounted for approximately 44% of our 2005 total segment operating revenues as compared to 32% in 2004 and 7% of our 2005 total segment income as compared to 2% in 2004. This segment reflects 100% of the results reported by Cingular, our wireless joint venture with BellSouth Corporation (BellSouth). Cingular offers both wireless voice and data communications services across the United States, providing cellular and PCS services. Although we analyze Cingular's revenues and expenses under the Cingular segment, we eliminate the Cingular segment in our consolidated financial statements. In our consolidated financial statements, we report our 60% proportionate share of Cingular's results as equity in net income of affiliates.

The **directory segment** accounted for approximately 5% of our 2005 total segment operating revenues as compared to 6% in 2004 and 27% of our 2005 total segment income as compared to 30% in 2004. This segment includes all directory operations, including Yellow and White Pages advertising and electronic publishing. Results for this segment are shown under the amortization method, which means that revenues and direct expenses are recognized ratably over the life of the directory title, typically 12 months. In November 2004, a subsidiary in our directory segment entered into a joint venture agreement with BellSouth and acquired the internet directory publisher YELLOWPAGES.COM (YPC) (see Note 6).

Other than those international investments acquired in our acquisition of ATTC, all investments with primarily international operations are included in the **international segment**, which accounted for less than 1% of our 2005 and 2004 total segment operating revenues and approximately 5% of our 2005 total segment income as compared to 12% in 2004. Most of our international investments reflected in the international segment are accounted for under the equity method, and therefore their results are reflected in segment income but not in segment revenue or expense. During 2004, we sold our interests in TDC, Belgacom and Telkom.

The **other segment** includes results from all corporate and other operations as well as the equity income from our investment in Cingular. In November 2005 we sold our paging operations. Although we analyze Cingular's revenues and expenses under the Cingular segment, we record its equity in net income of affiliates in this segment.

The following tables show components of results of operations by segment. We discuss significant segment results following each table. We discuss capital expenditures for each segment in "Liquidity and Capital Resources." Due to the fourth-quarter 2005 acquisition of ATTC and the application of purchase accounting rules required by GAAP, there are no period comparisons

available and thus percentage increases and decreases are not shown for the AT&T Corp. segment. In addition, Cingular's 2005 operating revenue and expense percentage increases and decreases are not considered meaningful, due to Cingular's fourth-quarter 2004 acquisition of AT&T Wireless, and are denoted with a dash.

Wireline Segment Results

	2005	2004	2003	Percent Change	
				2005 vs. 2004	2004 vs. 2003
Segment operating revenues					
Voice	\$19,904	\$20,796	\$21,986	(4.3)%	(5.4)%
Data	11,930	10,984	10,150	8.6	8.2
Long-distance voice	3,756	3,297	2,561	13.9	28.7
Other	1,855	1,810	1,843	2.5	(1.8)
Total Segment Operating Revenues	37,445	36,887	36,540	1.5	0.9
Segment operating expenses					
Cost of sales	16,814	16,603	15,941	1.3	4.2
Selling, general and administrative	9,505	9,206	8,794	3.2	4.7
Depreciation and amortization	7,121	7,454	7,763	(4.5)	(4.0)
Total Segment Operating Expenses	33,440	33,263	32,498	0.5	2.4
Segment Income	\$ 4,005	\$ 3,624	\$ 4,042	10.5%	(10.3)%

Our wireline segment operating income margin was 10.7% in 2005, compared to 9.8% in 2004 and 11.1% in 2003. The improvement in our wireline segment operating income margin in 2005 was due primarily to the continued growth in our Data and Long-distance voice revenues, which more than offset the loss of Voice revenue from the decline in total access lines (as shown in the following table) from 2004 to 2005 of approximately 2.9 million lines, or 5.6%, due to increasing competition.

Voice revenue declined due to customers continuing to disconnect primary and additional lines and using alternative technologies, such as wireless, and to a lesser extent VoIP and cable instead of phone lines for voice and data; our bundling strategy and other pricing responses to competitors' offerings, and; lower demand for services. Voice revenue also has declined over the past several years as our retail customers have disconnected their lines in order to obtain service from competitors who lease our UNE-P lines. However, that trend started to change in the third quarter of 2004 and for 2005, UNE-P lines (which include lines under commercial UNE-P replacement agreements) declined by 2.2 million, or 33.8%, from 2004 levels. The decline in UNE-P lines during 2005 is also attributable to UNE-P customers switching to alternative technologies as the UNE-P rules have changed; this decline has decreased our wholesale revenues. The impact of the UNE-P rules on our operating revenue is discussed below. (The UNE-P rules

are discussed in "Overview" and in "Operating Environment and Trends of the Business.") During 2005, our operating income margin was pressured on the cost side due to a charge to terminate existing agreements with WilTel and by higher costs caused by our growth initiatives in long-distance and DSL as well as, prior to the amendment of our agreement, our co-branded AT&T | DISH Network satellite TV service, sales in the large-business market and by higher repair costs caused by severe weather in our traditional SBC regions.

The decline in our wireline segment operating income margin in 2004 compared to 2003 was due primarily to the continued loss of voice revenue from the decline in total access lines from 2003 to 2004 of 2.3 million lines, or 4.3%. This revenue decline was caused by both an increase in customers disconnecting additional lines and using alternative technologies, our bundling strategy and other pricing responses to competitors' offerings as well as lower demand for services due to the uncertain U.S. economy (primarily in the first half of 2004). Revenue also has declined over the past several years as our retail customers disconnected their lines in order to obtain service from competitors who leased our UNE-P lines. Our operating income margin was also pressured by costs due to our growth initiatives in long-distance, DSL and the large-business market.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS (CONTINUED)**

Dollars in millions except per share amounts

Access Line Trends

Following is a summary of our switched access lines at December 31, 2005, 2004 and 2003:

Switched Access Lines

(In 000s)	2005	2004	2003	Increase (Decrease)	
				2005 vs. 2004	2004 vs. 2003
Retail Consumer					
Primary	22,793	23,206	23,948	(413)	(742)
Additional	3,890	4,322	4,894	(432)	(572)
Retail Consumer Subtotal	26,683	27,528	28,842	(845)	(1,314)
Retail Business	17,457	17,552	18,264	(95)	(712)
Retail Subtotal	44,140	45,080	47,106	(940)	(2,026)
Percent of total switched access lines	89.3%	86.1%	86.1%		
UNE-P	4,300	6,497	6,664	(2,197)	(167)
Resale	638	349	445	289	(96)
Wholesale Subtotal¹	4,938	6,846	7,109	(1,908)	(263)
Percent of total switched access lines	10.0%	13.1%	13.0%		
Payphone (retail and wholesale)	335	430	468	(95)	(38)
Percent of total switched access lines	0.7%	0.8%	0.9%		
Total Switched Access Lines	49,413	52,356	54,683	(2,943)	(2,327)
DSL Lines in Service	6,921	5,104	3,515	1,817	1,589

¹Wireline segment wholesale lines at December 31, 2005 include approximately 1.64 million lines purchased by ATTC.

Total switched access lines in service at December 31, 2005 declined 5.6% from December 31, 2004 levels. Retail access lines, while declining 2.1% from 2004 levels, represent 89.3% of total switched access lines at December 31, 2005, compared to 86.1% a year earlier. During this same period, wholesale lines (which include UNE-P, commercially negotiated UNE-P replacements and resale) decreased 27.9% and at December 31, 2005 represented 10.0% of total access lines, down from 13.1% a year earlier.

The decline in total access lines in 2005 reflects many factors, including the disconnection of additional lines as our existing customers purchase our DSL broadband services and for other reasons, and the continued growth in alternative communication technologies such as wireless, cable and other internet-based systems. While we lose some revenue when a wireline customer shifts from one of our retail lines to a competitor that relies on commercial UNE-P replacement agreements, the UNE-P rules or a resale agreement to offer service (i.e., one of our wholesale customers), we lose all customer revenue when a retail wireline customer shifts to an alternative technology such as cable, wireless or the Internet using VoIP or a competitor using its own traditional network. However, recently, declines in our retail business access lines have been partially offset by sales of our business internet-based systems (which are reported as Data revenues). We do not currently offer a residential internet-based service. The UNE-P rules are scheduled to end after a 12-month transition period that began March 11, 2005. Approximately 10% of our wholesale lines are still subject to the UNE-P transition rules. Based on marketing research, we believe that the majority of remaining customers that had used UNE-P service are shifting to an alternative technology or

to a competitor using its own network, as opposed to returning as our retail customers. Our wireline segment's operating margins will continue to be pressured by increasing customer shifts from our traditional retail base to either alternative technologies or competitors using commercial UNE-P replacement or resale agreements or their own facilities, as well as our pricing responses to retain or regain retail customers.

Total switched access lines in service at December 31, 2004 were 52.4 million, a decline of 2.3 million, or 4.3%, from December 31, 2003 levels. Of this total, retail access lines of 45.1 million represent 86.1% of total access lines. Wholesale lines represented 13.1% of total access lines at December 31, 2004.

Voice revenues decreased \$892, or 4.3%, in 2005 and \$1,190, or 5.4%, in 2004 primarily due to the loss of retail and wholesale access lines. The decline in retail lines primarily reflects increased competition, including customers using wireless, VoIP technology and cable instead of phone lines for voice and data, and the disconnection of additional lines for DSL service and other reasons. The decline in wholesale lines is related to the unwinding of the UNE-P rules which are scheduled to end in March 2006.

Retail access line declines decreased revenues approximately \$328 in 2005 and \$841 in 2004. Lower demand for wholesale services, primarily due to the decline in UNE-P lines provided to competitors, decreased revenue approximately \$145 in 2005. A decline in demand for calling features (e.g., Caller ID and voice mail), due primarily to the access line declines, decreased revenues approximately \$97 in 2005 and \$180 in 2004. Continued declines in demand for voice equipment located on customer premises decreased revenues approximately \$69 in 2005 and \$87 in

2004. Lower demand for retail payphone services decreased revenues approximately \$52 in 2005 and \$57 in 2004. We expect payphone access lines and revenue to continue to decline in future periods. Reduced demand for inside wire service agreements decreased revenues approximately \$36 in 2005 and \$61 in 2004. Revenue from "local plus" plans (expanded local calling area) declined approximately \$22 in 2005 and \$76 in 2004, as more customers chose broader long-distance and other bundled offerings.

Pricing responses to competitors' offerings and regulatory changes were essentially flat in 2005 and reduced revenues approximately \$390 in 2004. Revenue was lower by \$71 in 2005 from additional revenues we recorded in 2004 related to a September 2004 ruling by the CPUC that retroactively increased UNE-P rates we could charge in California. Revenue also was lower by \$37 in 2005 from additional revenue we recorded in 2004 related to Federal Communications Commission (FCC) proceedings on the inclusion of other postretirement benefit costs in previous tariff filings.

Partially offsetting these revenue declines were net settlements and billing adjustments with our wholesale customers which increased revenues approximately \$34 in 2005 and \$204 in 2004. Also in 2004, increased demand for wholesale services, primarily UNE-P lines provided to competitors, increased revenues approximately \$94.

Data revenues increased \$946, or 8.6%, in 2005 and \$834, or 8.2%, in 2004 primarily due to continued growth in DSL, our broadband internet-access service, high-capacity transport and sales of data equipment and services. DSL and dial-up internet service increased Data revenues approximately \$444 in 2005 and \$538 in 2004, reflecting an increase in DSL lines in service and, in 2005, was partially driven by lower-priced promotional offerings and pricing responses to competitors. The number of DSL lines in service grew to approximately 6.9 million, a 35.6% increase from 2004. At December 31, 2004 we served 5.1 million DSL lines, a 45.2% increase from December 31, 2003.

Revenue from our high-capacity transport services increased approximately \$273 in 2005 and declined \$81 in 2004. Our high-capacity transport services, which include DS1s and DS3s (types of dedicated high-capacity lines), and SONET (a dedicated high-speed solution for multi-site businesses), represented about 58% of total data revenues in 2005 and 61% in 2004. Our 2004 high-capacity results include revenue declines of approximately \$65 related to the 2000 federal Coalition for Affordable Local and Long Distance Services (CALLS) order and the September 2004 California order. Included in the 2004 decrease in high-capacity transport revenues was the favorable impact of a one-time MCI, Inc. (MCI) (formerly known as WorldCom) 2003 settlement of approximately \$45 which affected year-over-year comparisons.

Revenue from data equipment sales and network integration services increased approximately \$132 in 2005 and \$402 in 2004. Revenues from large-business customers typically consist of revenue from the initial installation of equipment followed by services provided over multiple years. The significant increase in 2004 reflected our initial expansion into the large-business market following our late 2003 entry into nationwide long-distance.

Long-distance voice revenues increased \$459, or 13.9%, in 2005 and \$736, or 28.7%, in 2004. These increases were primarily driven by the increase in long-distance lines in service in 2005 and 2004. The number of long-distance lines in service in the wireline segment at December 31, 2005 grew to approximately 23.5 million, a 12.6% increase from 2004. At December 31, 2004, we served 20.9 million lines, a 44.8% increase from December 31, 2003. Sales of combined long-distance and local calling fixed-fee offerings (referred to as "bundling") also contributed to the increased long-distance revenues and lines. Long-distance revenues continued to increase in our traditional SBC Midwest, West and Southwest regions with the most significant improvements in results occurring in our Midwest region (Michigan, Illinois, Indiana, Ohio and Wisconsin). Our long-distance revenue growth slowed in 2005, reflecting continuing market maturity since we began providing service throughout our regions in late 2003.

Retail long-distance revenues increased approximately \$467 in 2005 and \$825 in 2004, reflecting our higher long-distance penetration levels. Continued growth in wholesale long-distance services sold to Cingular and our international and other long-distance services increased revenues approximately \$155 in 2005 and \$282 in 2004. Partially offsetting these increases was a decline of approximately \$139 in 2005 and \$340 in 2004 due to pricing responses to increased competition and a reduction in our billed minutes of use mainly related to the increased sales of our fixed-fee bundles, which do not separately bill for minutes of use.

Other operating revenues increased \$45, or 2.5%, in 2005 and decreased \$33, or 1.8%, in 2004. Our co-branded AT&T | DISH Network satellite TV service increased revenue approximately \$196 in 2005 and \$94 in 2004. We expect future growth in revenues from this service to moderate as we restructured our agreement with EchoStar in September 2005 (see "Other Business Matters") to record only commission revenue when signing up future customers. Price increases, primarily in directory assistance, increased revenues approximately \$23 in 2005 and \$48 in 2004. Partially offsetting these revenue increases was lower demand for directory and operator assistance, billing and collection services provided to other carriers, wholesale and other miscellaneous products and services, various one-time billing adjustments and other pricing changes decreased revenue approximately \$190 in 2005 and \$148 in 2004. Commission revenue received from Cingular related to Cingular customers added through our sales sources increased approximately \$8 in 2005 after decreasing \$27 in 2004, reflecting more stringent credit policies put in place in 2004.

Cost of sales expenses increased \$211, or 1.3%, in 2005 and \$662, or 4.2%, in 2004. Cost of sales consists of costs we incur to provide our products and services, including costs of operating and maintaining our networks. Costs in this category include our repair technicians and repair services, certain network planning and engineering expenses, operator services, information technology, property taxes related to elements of our network, and payphone operations. Pension and postretirement costs, net of amounts capitalized as part of construction labor,

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Dollars in millions except per share amounts

are also included to the extent that they are allocated to our network labor force and other employees who perform the functions listed in this paragraph.

Traffic compensation expense (for access to another carrier's network) increased approximately \$330 in 2005 and \$122 in 2004. Growth in our long-distance service generated approximately \$192 of the increase in 2005 and \$286 in 2004, partially offset by lower rates paid for local traffic (telephone calls) terminating on competitor networks and wireless customers. Expense also increased approximately \$164 in 2005 resulting from reduced expense in 2004 from non-recurring traffic compensation settlements. Offsetting these increases, traffic compensation expense decreased approximately \$26 in 2005 related to a carrier settlement.

Costs associated with equipment sales and related network integration services and, prior to the amendment of our agreement, our co-branded AT&T | DISH Network satellite TV service increased approximately \$195 in 2005 and \$603 in 2004, reflecting our emphasis on growth in DSL and sales in the large-business market and video. Prior to restructuring our relationship with EchoStar in September 2005, our co-branded AT&T | DISH Network satellite TV service had relatively high initial acquisition costs. Costs associated with equipment for large-business customers (as well as DSL and, previously, video) typically are greater than costs associated with services that are provided over multiple years. Costs in 2004 reflect our initial expansion into the large-business market.

Salary and wage merit increases and other bonus accrual adjustments increased expense approximately \$170 in 2005 and \$356 in 2004. Merger severance accruals increased expenses approximately \$176 in 2005. We also incurred repair costs of approximately \$100 in 2005 primarily related to severe weather in our regions, including California.

Partially offsetting these increases were lower employee levels which decreased expenses, primarily salary and wages, approximately \$322 in 2005 and \$208 in 2004. Nonemployee-related expenses such as contract services, agent commissions and materials and supplies costs decreased approximately \$100 in 2005 and \$148 in 2004.

Additionally, expenses decreased \$154 in 2005 due to the one-time accrual in 2004 for a retiree bonus as a result of the settlement of our labor contract negotiations in the second quarter of 2004. Benefit expenses, consisting primarily of our combined net pension and postretirement cost, decreased approximately \$12 in 2005, primarily resulting from changes made to management medical coverage in 2005. In addition, changes in 2005 to phone concessions for out-of-region retirees reduced expenses by approximately \$20 in 2005. Benefit expenses decreased by \$306 in 2004 compared to 2003 reflecting changes in nonmanagement retirees' medical coverage and our accounting for the Medicare Act.

As part of an internal business unit realignment during the second quarter of 2005, expenses incurred by the affected unit in 2004 were reported in cost of sales, while in 2005 costs incurred by this group have been reported as selling expenses. This resulted in reduced cost of sales expenses of \$148 in 2005, and a corresponding increase in selling, general and administrative expenses in 2005.

Selling, general and administrative expenses increased \$299, or 3.2%, in 2005 and \$412, or 4.7%, in 2004. Selling, general and administrative expenses consist of our provision for uncollectible accounts; advertising costs; sales and marketing functions, including our retail and wholesale customer service centers; centrally managed real estate costs, including maintenance and utilities on all owned and leased buildings; credit and collection functions, and; corporate overhead costs, such as finance, legal, human resources and external affairs. Pension and postretirement costs are also included to the extent they relate to employees who perform the functions listed in this paragraph.

Salary and wage merit increases and other bonus accrual adjustments increased expenses approximately \$108 in 2005 and \$127 in 2004. Expenses increased during 2005 due to a charge of \$236 to terminate existing agreements with WilTel, which will continue to provide transitional and out-of-market long-distance services under a new agreement that commenced in November 2005 as a result of our acquisition of ATTC. ATTC merger-related asset impairment charges of approximately \$349 and merger-related severance cost accruals of \$107 increased expenses in 2005. Expenses increased approximately \$111 in 2004 due to higher severance accruals.

Partially offsetting these increases were lower employee levels, which decreased expenses, primarily salary and wages, approximately \$264 in 2005 and \$36 in 2004. Our provision for uncollectible accounts decreased approximately \$55 in 2005 and \$21 in 2004 as we experienced fewer losses from our retail customers and a decrease in bankruptcy filings by our wholesale customers. Advertising expense decreased approximately \$20 in 2005 and \$43 in 2004 primarily driven by higher costs in 2003 from our launch of long-distance service in new markets and bundling initiatives, which declined slightly in 2004 and 2005. Nonemployee-related expenses, such as contract services, agent commissions and materials and supplies costs, decreased approximately \$59 in 2005 and increased \$188 in 2004. Other employee-related expenses, including travel, training and conferences, decreased approximately \$21 in 2005 and increased \$29 in 2004.

Expenses decreased \$79 in 2005 due to the one-time accrual in 2004 for a retiree bonus resulting from the settlement of our labor contract negotiations in 2004. Benefit expenses, consisting primarily of our combined net pension and postretirement cost, decreased approximately \$66 in 2005 primarily due to changes made to management medical coverage in 2005. In addition, changes in 2005 to phone concessions for out-of-region retirees reduced expenses by approximately \$73 in 2005. Benefit expenses decreased by \$22 in 2004 compared to 2003 reflecting changes in nonmanagement retirees' medical coverage and our accounting for the Medicare Act.

As part of an internal business unit realignment during the second quarter of 2005, expenses incurred by the affected unit in 2004 were reported in cost of sales, while in 2005 costs incurred by this group have been reported as selling expenses. This resulted in increased selling, general and administrative expenses of \$148 in 2005 and a corresponding reduction in cost of sales in 2005.

Depreciation and amortization expenses decreased \$333, or 4.5%, in 2005 and \$309, or 4.0%, in 2004. Lower expenses in 2005 and 2004 were due primarily to significantly lower capital expenditure levels since 2001.

**AT&T Corp.
Segment Results**

	2005	2004	2003
Segment operating revenues			
Voice	\$ 361	\$ —	\$ —
Data	1,129	—	—
Long-distance voice	1,208	—	—
Other	189	—	—
Total Segment Operating Revenues	2,887	—	—
Segment operating expenses			
Cost of sales	1,686	—	—
Selling, general and administrative	669	—	—
Depreciation and amortization	414	—	—
Total Segment Operating Expenses	2,769	—	—
Segment Operating Income	118	—	—
Equity in Net Income of Affiliates	2	—	—
Segment Income	\$ 120	\$ —	\$ —

The AT&T Corp. segment consists of the results of ATTC after we completed our acquisition on November 18, 2005. Our AT&T Corp. segment operating income margin was 4.1% for the 43-day period ended December 31, 2005. The results included the effects of the purchase accounting rules required under GAAP. The discussion below includes our understanding of the trends of the business prior to and following the November acquisition.

**AT&T Corp.
Pro Forma Segment Operating Revenues**

	Three-Month Period Ended			
	Dec 31, 2005	Sep 30, 2005	Jun 30, 2005	Mar 31, 2005
AT&T Corp. Operating Revenues	\$3,481 ¹	\$6,620	\$6,760	\$7,015
AT&T Corp. Segment Operating Revenues	2,887 ²	—	—	—
Pro Forma AT&T Corp. Segment Operating Revenues	\$6,368	\$6,620	\$6,760	\$7,015

¹AT&T Corp. results from October 1, 2005 – November 18, 2005.

²AT&T Corp. segment results from November 19, 2005 – December 31, 2005.

Revenues from business customers declined during 2005 reflecting continued pricing pressures in traditional voice and data products, offset in part by growth in IP-based products and E-services. Revenues from consumer

Voice revenues of \$361 for the period have been negatively impacted by ATTC's 2004 decision to shift emphasis away from residential customer acquisitions as a result of changes in the federal regulatory environment over the past two years. For these changes, see the "Regulatory Developments" section.

Data revenues of \$1,129 have been negatively impacted by competitive pricing pressure. Positively impacting data revenue were advanced services, such as Enhanced Virtual Private Network and IP-enabled frame relay services.

Long-distance voice revenues of \$1,208 have been negatively impacted by competition, which has led to lower prices in business markets and loss of consumer and small- and medium-sized business market share, and substitution which has led to lower volumes.

Other operating revenues of \$189 have been negatively impacted by contract terminations and renegotiations.

Cost of sales of \$1,686 includes the costs of operating and maintaining the network, as well as traffic compensation expense. Traffic compensation expense was approximately \$1,102, or 65%, of total costs of sales.

Selling, general and administrative expenses of \$669 include our provision for uncollectible accounts and sales and marketing functions.

Depreciation and amortization expenses of \$414 included amortization expense of \$192 associated with acquired intangible assets, of which \$184 was from customer-related intangibles.

Supplemental Information

To provide improved comparability versus previous quarters, below is a supplemental table providing quarterly pro forma operating revenues of the AT&T Corp. segment. On a pro forma operating revenue basis, this segment would have represented 26% of total segment operating revenues for 2005 (segment operating revenues include 100% of our Cingular segment operating revenues).

(residential and small- and medium-sized businesses) customers declined during 2005 reflecting industry trends and ATTC's decision (prior to the acquisition) to shift its emphasis to other segments of the business.

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Dollars in millions except per share amounts

**Cingular
Segment Results**

	2005	2004	2003	Percent Change ¹	
				2005 vs. 2004	2004 vs. 2003
Segment operating revenues					
Service	\$30,638	\$17,602	\$14,317	—	22.9 %
Equipment	3,795	1,963	1,260	—	55.8
Total Segment Operating Revenues	34,433	19,565	15,577	—	25.6
Segment operating expenses					
Cost of services and equipment sales	14,387	7,611	5,806	—	31.1
Selling, general and administrative	11,647	7,349	5,428	—	35.4
Depreciation and amortization	6,575	3,077	2,089	—	47.3
Total Segment Operating Expenses	32,609	18,037	13,323	—	35.4
Segment Operating Income	1,824	1,528	2,254	19.4	(32.2)
Interest Expense	1,260	900	856	40.0	5.1
Equity in Net Income (Loss) of Affiliates	5	(415)	(333)	—	(24.6)
Other – net	(38)	(70)	(60)	45.7	(16.7)
Segment Income	\$ 531	\$ 143	\$ 1,005	—	(85.8)%

¹Cingular's 2005 operating revenue and expense percentage increases and decreases are not considered meaningful due to Cingular's fourth-quarter 2004 acquisition of AT&T Wireless and are denoted with a dash.

Accounting for Cingular

We account for our 60% economic interest in Cingular under the equity method of accounting in our consolidated financial statements since we share control equally (i.e., 50/50) with our 40% economic partner BellSouth in the joint venture. We have equal voting rights and representation on the Board of Directors that controls Cingular. This means that our consolidated results include Cingular's results in the "Equity in net income of affiliates" line. However, when analyzing our segment results, we evaluate Cingular's results on a stand-alone basis using information provided by Cingular during the year. Accordingly, in our segment presentation, we present 100% of Cingular's revenues and expenses under "Segment operating revenues" and "Segment operating expenses." Including 100% of Cingular's results in our segment operations (rather than 60% in equity in net income of affiliates) affects the presentation of this segment's revenues, expenses, operating income, nonoperating items and segment income but does not affect our consolidated net income. We discuss Cingular's liquidity and capital expenditures under the heading "Cingular" within the "Liquidity and Capital Resources."

In the first quarter of 2005, to be consistent with industry practices, Cingular changed its income statement presentation for the current and prior-year periods to record billings to customers for various state gross receipts taxes and other fees as "Service" revenues and the taxes assessed by the various state jurisdictions and other fees as "Cost of services and equipment sales." This amount totaled approximately \$129 in 2004 and \$94 in 2003. Operating income and net income for all restated periods were not affected.

Acquisition of AT&T Wireless

On October 26, 2004, Cingular acquired AT&T Wireless for approximately \$41,000 in cash. We and BellSouth funded,

by means of an equity contribution to Cingular, a significant portion of the acquisition's purchase price. Based on our 60% equity ownership of Cingular, and after taking into account cash on hand at AT&T Wireless, we provided approximately \$21,600 to fund the purchase price. Equity ownership and management control of Cingular remains unchanged after the acquisition.

In the first half of 2005, Cingular completed all required divestitures of assets and spectrum in certain markets in response to the agreement made with the U.S. Department of Justice (DOJ) and the FCC as a condition to receiving regulatory approval to acquire AT&T Wireless. These required divestitures included Cingular's sale of certain former AT&T Wireless assets and properties, including licenses, network assets and subscribers that Cingular operated in several markets.

In October 2005, Cingular approved the final phase of its network integration plan. This phase will involve integrating its Global System for Mobile Communication (GSM) networks, decommissioning redundant cell sites and core network elements, and swapping vendor equipment in various markets in order to have similar equipment in each market. Cingular expects to complete its network integration plan by the end of 2006 and to incur costs of approximately \$580 related to this phase of its plan, which includes integration exit cost liabilities of \$350 that were recorded as an adjustment to the AT&T Wireless purchase price allocation. In connection with the approval of this final phase, Cingular reduced its network equipment balance by approximately \$60 for equipment removed from service during 2005. Although Cingular will be decommissioning much of its Time Division Multiple Access (TDMA) network it will continue providing analog services to some customers through February 2008.

Cingular's Customer and Operating Trends

As of December 31, 2005, Cingular served approximately 54.1 million cellular/PCS (wireless) customers, compared to 49.1 million at December 31, 2004 and 24.0 million at December 31, 2003. Cingular's increase in customer gross

additions was primarily due to the acquisition of AT&T Wireless in late October 2004. The increase was also due to Cingular's larger distribution network, its broad range of service offerings and increased advertising. Cingular's recent customer activity is listed below:

Wireless Customer Activity

(in 000s)	Three-Month Period Ended				
	Dec 31, 2005	Sep 30, 2005	Jun 30, 2005	Mar 31, 2005	Dec 31, 2004
Gross additions	5,136	4,386	4,292	4,672	4,914
Net additions	1,820	867	952	1,367	1,699
Other adjustments ¹	32	(17)	140	(149)	21,761
Net additions including other adjustments ¹	1,852	850	1,092	1,218	23,460

¹Other adjustments include customers gained or lost through property divestitures related to the AT&T Wireless acquisition and other adjustments. In the fourth quarter of 2004, other adjustments included approximately 21.9 million subscribers related to Cingular's acquisition of AT&T Wireless.

Competition and the slowing rate of new wireless users as the wireless market matures will continue to adversely impact Cingular's gross additions and revenue growth, increase expenses and put pressure on margins. Cingular expects that future revenue growth will become increasingly dependent on minimizing customer turnover (customer churn) and increasing average revenue per user/customer (ARPU). Cingular's ARPU has weakened over the past several years as it has offered a broader array of plans to expand its customer base and responded to increasing competition, resulting in pricing reductions. While Cingular's ARPU has somewhat stabilized recently, Cingular nevertheless expects continued pressure on ARPU notwithstanding increasing revenue from data services. Cingular expects its cost of services to continue increasing due to higher network system usage, including the costs Cingular is now paying T-Mobile USA (T-Mobile) for the use of its network in California and Nevada, higher costs as Cingular continues to integrate AT&T Wireless' network and operations, and, to a lesser extent, increased expenses related to operating, maintaining and decommissioning TDMA networks that duplicated GSM networks while integrating the networks acquired from AT&T Wireless. Cingular's remaining purchase commitment to T-Mobile was approximately \$520 at December 31, 2005. Operating costs will substantially increase in the event that Cingular's network expansion in California and Nevada is not completed prior to fulfilling the purchase commitment with T-Mobile.

ARPU declined 0.1% in 2005 and 3.9% in 2004. The decline in ARPU was due to a decrease in local service and net roaming revenue per customer partially offset by an increase in average data revenue per customer and increased long-distance revenue per customer. Local service revenue per customer declined primarily due to customer shifts to all-inclusive rate plans that offer lower monthly charges and "rollover" minutes (which allow customers to carry over unused minutes from month to month for up to one year) as well as Cingular's free mobile-to-mobile plans, which allow Cingular customers to call other Cingular customers at no charge. An increase in customers on rollover plans tends to lower average monthly revenue per customer since unused minutes (and associated revenue) are deferred until subsequent months for up to one year.

The effective management of wireless customer churn is critical to Cingular's ability to maximize revenue growth and maintain and improve margins. Cingular's wireless customer churn rate is calculated by dividing the aggregate number of wireless customers (prepaid and postpaid) who cancel service during each month in a period by the total number of wireless customers at the beginning of each month in that period. Cingular's churn rate was 2.2% in 2005, down from 2.7% in 2004 and 2003.

The churn rate for Cingular's postpaid customers was 1.9% in 2005, down from 2.3% in 2004 and 2003. The decline in postpaid churn reflects benefits from the acquisition of AT&T Wireless, including more affordable rate plans, broader network coverage, higher network quality, exclusive devices and free mobile-to-mobile calling among Cingular's 54.1 million customers.

The decline in Cingular's churn rate compared to 2004 resulted primarily from a change in methodology of calculating churn related to reseller customers. Beginning in the first quarter of 2005, Cingular adopted a new reseller churn calculation methodology that resulted in an aggregate churn calculation that is more comparable with its major competitors. Prior to 2005, Cingular included gross reseller disconnects in its churn calculation. Effective with the first quarter of 2005, Cingular's churn calculation is based on total net reseller disconnects. This change resulted in an improvement to 2005 reported churn of approximately 32 basis points. Partially offsetting Cingular's churn decline was an increase in prepaid customer churn.

Cingular's Operating Results

Our Cingular segment operating income margin was 5.3% in 2005, 7.8% in 2004 and 14.5% in 2003. The lower margins in 2005 and 2004 compared to 2003 were caused by expenses increasing at a higher rate than revenues, which was primarily attributable to the acquisition of AT&T Wireless in late October 2004. However, our Cingular segment operating income margin improved every quarter during 2005 compared to the fourth quarter of 2004. Cingular's operating income margin was 6.2% in the fourth quarter of 2005, 7.5% in the third quarter, 5.9% in the second quarter and 1.4% in the first quarter of 2005 compared to an operating loss margin of 2.1% in the fourth quarter of 2004.

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Cingular's operating expenses increased \$14,572 in 2005 and \$4,714 in 2004. More than offsetting these operating expenses was revenue growth of \$14,868 in 2005. In 2004, revenue growth of \$3,988 partially offset the increased operating expenses.

Service revenues are comprised of local voice and data services, roaming, long-distance and other revenue.

Offsetting 2005 Service revenues was approximately \$31 in customer bill credits issued to customers affected by hurricanes. Service revenues increased \$13,036 in 2005 and \$3,285 in 2004 and consisted of:

- Local voice revenues, which increased approximately \$10,219 in 2005 and \$2,741 in 2004 primarily due to the acquisition of AT&T Wireless (due to Cingular's significant increase in average number of wireless customers). Increased Universal Service Fund (USF) and regulatory compliance fees also contributed to the local voice revenues increase in 2005 and 2004.
- Data service revenues, which increased \$1,785 in 2005 and \$438 in 2004 primarily due to the inclusion of former AT&T Wireless customers (who on average were heavier data users than Cingular customers), increased average data revenue per customer and increased use of text messaging services. Data service revenues represented approximately 7.8% of Cingular's total revenues in 2005 and 4.6% in 2004.
- Roaming revenues from Cingular customers and other wireless carriers for use of Cingular's network, which increased \$655 in 2005 and \$6 in 2004. The 2005 increase was primarily due to roaming revenues from the acquired AT&T Wireless customer base.
- Long-distance and other revenue, which increased \$377 in 2005 and \$100 in 2004 primarily due to increased long-distance revenues from the acquired AT&T Wireless customer base as well as increased domestic and international long-distance calling.

Equipment revenues increased \$1,832 in 2005 and \$703 in 2004 due to increased handset revenues primarily as a result of significantly higher gross customer additions and increases in existing customers upgrading their units. Upgrade unit sales reflect an increase in GSM upgrades and Cingular's efforts to migrate former AT&T Wireless customers to Cingular service offerings.

Cost of services and equipment sales expenses increased \$6,776 in 2005 and \$1,805 in 2004 primarily due to increased cost of services resulting from incremental costs related to the acquired AT&T Wireless network. Included in the 2005 increase were integration costs of approximately \$195 related to the acquired AT&T Wireless network and hurricane-related costs of \$97.

Cost of services increased \$4,581 in 2005 and \$962 in 2004. Cost of services increased due to the following:

- Increases in network usage with a minutes of use increase of more than 110% in 2005 and more than 50% in 2004 primarily due to the increase in subscribers related to Cingular's acquisition of AT&T Wireless.
- Increased costs Cingular is now paying T-Mobile for the use of its network in California and Nevada.

- Increased expenses related to operating, maintaining and decommissioning TDMA networks that duplicated GSM networks while integrating the networks acquired from AT&T Wireless.
- Higher roaming and long-distance cost and increased USF and regulatory fees related to the increase in the customer base.

Equipment sales expense increased \$2,195 in 2005 and \$843 in 2004 primarily due to higher handset unit sales associated with the 46.1% increase in gross customer additions in 2005 and more than 30.0% in 2004, existing customers upgrading their units and the continued migration of former AT&T Wireless customers to Cingular service offerings. Equipment costs increased at a higher rate than equipment revenues due to Cingular's sales of handsets below cost, through direct sales sources, to customers who committed to one-year or two-year contracts or in connection with other promotions.

Selling, general and administrative expenses increased \$4,298 in 2005 and \$1,921 in 2004 primarily due to incremental expenses associated with the acquisition of AT&T Wireless. These increases include integration costs of approximately \$264 in 2005 and \$277 in 2004, including employee termination costs, re-branding and advertising of the Cingular and AT&T Wireless combination and customer service and systems integration costs. Also included in this increase were hurricane-related costs of \$19 in 2005.

Total selling expenses increased \$1,385 in 2005 and \$873 in 2004 primarily due to the increase in gross customer additions previously mentioned. Total selling expenses include sales, marketing, advertising and commissions expense. Cingular's sales expense increased approximately \$462 in 2005 and \$232 in 2004 primarily due to increased sales personnel costs associated with the acquired AT&T Wireless sales force. Commissions expense increased approximately \$494 in 2005 and \$289 in 2004 and advertising and marketing expenses increased \$429 in 2005 and \$352 in 2004.

General and administrative expenses increased \$2,913 in 2005 and \$1,048 in 2004 primarily due to the previously mentioned incremental expenses from AT&T Wireless and integration costs. General and administrative expenses include customer service, upgrade commissions, billing, bad debt, other maintenance and other administrative expense. Customer service expenses increased approximately \$960 in 2005 and \$395 in 2004 due to a higher number of employees and employee-related expenses related to the significant increase in customers, as well as customer retention and customer service improvement initiatives. Other administrative expenses increased approximately \$926 in 2005 and \$307 in 2004 primarily due to incremental expenses associated with the acquired AT&T Wireless administrative functions. Billing, bad debt and other customer maintenance expense increased approximately \$766 in 2005 and \$305 in 2004 primarily due to the significant increase in Cingular's customer base. Upgrade commissions increased approximately \$261 in 2005 and \$41 in 2004 due to the previously mentioned increased customer migration and handset upgrade activity.

Depreciation and amortization expenses increased \$3,498 in 2005 and \$988 in 2004. These increases include approximately \$417 of integration costs in 2005. Depreciation expense increased approximately \$2,249 in 2005 and \$635 in 2004 primarily due to incremental depreciation associated with the property, plant and equipment acquired in the AT&T Wireless acquisition and depreciation related to Cingular's ongoing capital spending associated with its GSM network. Additionally, depreciation expense increased due to accelerated depreciation on certain TDMA network assets based on Cingular's projected transition of network traffic to GSM technology and accelerated depreciation on certain other network assets. Substantially all of Cingular's TDMA assets are anticipated to be fully depreciated by the end of 2007.

Amortization expense increased approximately \$1,249 in 2005 and \$353 in 2004 primarily due to the amortization of the AT&T Wireless customer contracts and other intangible assets acquired.

Supplemental Information

Because Cingular's acquisition of AT&T Wireless has a significant effect on comparative financial information, we have included the following sequential quarterly results for comparative purposes.

Cingular's operating margins have increased since the acquisition reflecting the continued increase in the number of wireless customers, continued progress in its merger-integration initiatives, as well as continued improvement in customer churn compared with 2004.

Cingular Sequential Segment Results

	Three-Month Period Ended				
	Dec 31, 2005	Sep 30, 2005	Jun 30, 2005	Mar 31, 2005	Dec 31, 2004
Segment operating revenues					
Service revenues	\$7,779	\$7,721	\$7,719	\$7,419	\$6,313
Equipment revenues	1,070	1,025	890	810	806
Total Segment Operating Revenues	8,849	8,746	8,609	8,229	7,119
Segment operating expenses					
Cost of services and equipment sales	3,758	3,667	3,523	3,439	2,939
Selling, general and administrative	2,812	2,881	2,953	3,001	2,947
Depreciation and amortization	1,730	1,541	1,629	1,675	1,386
Total Segment Operating Expenses	8,300	8,089	8,105	8,115	7,272
Segment Operating Income (Loss)	549	657	504	114	(153)
Interest Expense	292	304	326	338	303
Equity in Net Income (Loss) of Affiliates	1	1	1	2	(114)
Other – net	(6)	(28)	(8)	4	13
Segment Income (Loss)	\$ 252	\$ 326	\$ 171	\$ (218)	\$ (557)

Directory Segment Results

	2005	2004	2003	Percent Change	
				2005 vs. 2004	2004 vs. 2003
Total Segment Operating Revenues	\$3,714	\$3,759	\$3,773	(1.2)%	(0.4)%
Segment operating expenses					
Cost of sales	1,103	1,022	964	7.9	6.0
Selling, general and administrative	612	622	673	(1.6)	(7.6)
Depreciation and amortization	5	9	21	(44.4)	(57.1)
Total Segment Operating Expenses	1,720	1,653	1,658	4.1	(0.3)
Segment Operating Income	1,994	2,106	2,115	(5.3)	(0.4)
Equity in Net Income (Loss) of Affiliates	(5)	—	—	—	—
Segment Income	\$1,989	\$2,106	\$2,115	(5.6)%	(0.4)%

In September 2004, we sold our interest in the directory advertising business in Illinois and northwest Indiana. Our directory segment results exclude the results of those operations (see Note 17). In November 2004, our directory segment entered into a joint venture agreement with BellSouth and acquired the internet directory publisher, YPC. We account for YPC under the equity method of accounting.

Our directory segment operating income margin was 53.6% in 2005, 56.0% in 2004 and 56.1% in 2003. The segment operating income margin decrease in 2005 is a result of both higher expenses and lower revenues. The segment operating income margin stability in 2004 is due to our revenues and expenses for both periods being relatively flat.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
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Dollars in millions except per share amounts

Operating revenues decreased \$45, or 1.2%, in 2005 and \$14, or 0.4%, in 2004. The decrease in revenues in 2005 was primarily due to a decrease of approximately \$74 in our local Yellow Pages advertising, which was partially offset by an increase of \$39 in internet advertising revenue. Revenues in 2004 decreased primarily in our local Yellow Pages advertising, which decreased approximately \$95 in 2004, and was partially offset by an increase of \$30 in internet advertising revenue and an improvement of \$27 in revenue adjustments related to customer satisfaction. These results reflect the impact of competition from other publishers, other advertising media and continuing economic pressures on advertising customers.

Cost of sales increased \$81, or 7.9%, in 2005 and \$58, or 6.0%, in 2004. The increase in 2005 was primarily driven by

higher costs for internet traffic of approximately \$22, publishing of \$17 and distribution of \$9. In 2004, cost of sales increased due to higher costs for commissions, publishing and distribution which were partially offset by decreased costs for paper and printing.

Selling, general and administrative expenses decreased \$10, or 1.6%, in 2005 and \$51, or 7.6%, in 2004. The expense reduction in 2005 was primarily due to lower advertising expense. Decreased expenses in 2004 were primarily due to lower uncollectible expense of approximately \$68, partially offset by increases in advertising expense of \$25 and increased employee benefit-related costs of \$14.

**International
Segment Results**

				Percent Change	
	2005	2004	2003	2005 vs. 2004	2004 vs. 2003
Total Segment Operating Revenues	\$ 10	\$ 22	\$ 30	(54.5)%	(26.7)%
Total Segment Operating Expenses	28	31	47	(9.7)	(34.0)
Segment Operating Income (Loss)	(18)	(9)	(17)	—	47.1
Equity in Net Income of Affiliates	395	812	606	(51.4)	34.0
Segment Income	\$377	\$803	\$589	(53.1)%	36.3%

Our international segment consists primarily of equity investments in international companies, the income from which we report as equity in net income of affiliates. Revenues from the segment's direct international operations are less than 1% of our consolidated revenues.

Our earnings from foreign affiliates are sensitive to exchange-rate changes in the value of the respective local currencies. See Note 1 for a discussion of foreign currency translation. Our foreign investments are recorded under GAAP, which include adjustments for the purchase method of accounting and exclude certain adjustments required for local reporting in specific countries. In discussing Equity in Net Income of Affiliates, all dollar amounts refer to the effect on our income. The following table summarizes the individual results for our significant equity holdings in the international segment. A discussion of these results follows. See "Other income (expense) – net" and Note 2 for information on the sale of several investments during 2004.

Segment operating revenues decreased \$12, or 54.5%, in 2005 and \$8, or 26.7%, in 2004. Revenues declined primarily due to forgone management-fee revenues from the disposition of investments.

Segment operating expenses decreased \$3, or 9.7%, in 2005 and \$16, or 34.0%, in 2004. Expenses in 2005 declined primarily due to lower employee costs resulting from fewer foreign-based employees. Expenses in 2004 declined primarily due to lower corporate-allocated charges.

Our equity in net income of affiliates by major investment at December 31, are listed below:

	2005	2004	2003
América Móvil	\$198	\$132	\$ 76
Belgacom ¹	—	49	28
TDC ¹	—	328	182
Telkom South Africa ¹	—	115	121
Telmex	212	180	196
Other	(15)	8	3
Equity in Net Income of Affiliates	\$395	\$812	\$606

¹Investment sold in 2004.

Equity in net income of affiliates decreased \$417, or 51.4%, in 2005 and increased \$206, or 34.0%, in 2004. The decrease in 2005 was primarily due to gains that occurred in 2004, and foregone equity income from the disposition of investments. Increases at América Móvil and Telmex reflect better operating results at both companies and reduced income taxes at América Móvil.

The increase in 2004 was primarily due to a gain of approximately \$235 from TDC, related to the sale of its interest in Belgacom. Equity income in 2004 also increased due to a settlement loss of \$160 in 2003 on a transfer of pension liabilities which affected year-over-year comparisons. The settlement loss in 2003 resulted from a transfer of pension liabilities by Belgacom to the Belgian government

and included a loss of approximately \$115 from Belgacom and TDC's loss of \$45 associated with the same transaction. Equity in net income of affiliates in 2004 also increased approximately: (1) \$53 due to favorable operating results, primarily at América Móvil, (2) \$46 due to prior-year restructuring charges at TDC and (3) \$65 due to favorable financing and exchange-rate impacts. These increases were partially offset by lower equity income of approximately

\$314 related to asset sales, including: (1) \$131 from the sale of our and TDC's investment in Belgacom, (2) \$38 from the sale of our interest in Telkom and (3) \$145 from the sale of our interest in TDC. The increases were also offset by combined charges of approximately \$51 for 2004 restructuring charges at TDC and impairment of our goodwill associated with a TDC subsidiary.

Other Segment Results

	2005	2004	2003	Percent Change	
				2005 vs. 2004	2004 vs. 2003
Total Segment Operating Revenues	\$253	\$244	\$263	3.7%	(7.2)%
Total Segment Operating Expenses	183	64	119	—	(46.2)
Segment Operating Income	70	180	144	(61.1)	25.0
Equity in Net Income of Affiliates	217	61	647	—	(90.6)
Segment Income	\$287	\$241	\$791	19.1%	(69.5)%

Our other segment results consist primarily of corporate and other operations. In November 2005, we sold our paging operations.

Segment operating revenues increased in 2005 as a result of higher revenues from capital leasing subsidiaries. Segment operating revenues decreased in 2004 as a result of lower revenues from paging and capital leasing subsidiaries.

Equity in Net Income of Affiliates primarily represents the equity income from our investment in Cingular.

OPERATING ENVIRONMENT AND TRENDS OF THE BUSINESS

2006 Revenue Trends Our acquisition of ATTC will help change the focus of our company toward broadband/data and business revenues. Cingular's late-2004 acquisition of AT&T Wireless also increased our potential for growth in the wireless area. During 2005, we experienced slight growth in our traditional wireline operations and for 2006 we expect similar growth in these traditional areas. Because of the late 2005 completion date of the ATTC acquisition, we expect reported revenues to increase in 2006 compared to 2005. However, in terms of business trends, we expect our 2006 and 2007 revenues to reflect continuing but diminishing declines from ATTC operations, as we integrate their business operations. If we include our proportionate share of Cingular's revenues in analyzing our overall company prospects, we expect total year-over-year revenue growth to turn positive in 2008. Our revenue expectations assume that we will experience improvement in our retail access line trends, partially offset by a decline in the number of wholesale lines we provide, based on favorable developments in the federal regulatory environment (see the "Regulatory Developments" section). We also expect to expand services utilizing our broadband network (see "Project Lightspeed" discussed in "Expected Growth Areas") as well as the national business market as a result of the ATTC acquisition. Accordingly, we assume that we will experience continued growth in DSL and additional opportunities in the national data markets (see "Expected Growth Areas"). We also assume continued long-distance subscriber growth in our former SBC long-distance business,

but at a lower rate as that long-distance business continues to mature. During the fourth quarter of 2004, Cingular completed its acquisition of AT&T Wireless and is now the largest wireless service provider in the U.S. While Cingular's revenues are not included in our consolidated revenues, we expect the increased availability and competitiveness of its service offerings will enhance our bundling opportunities (see "Cingular" discussed in "Expected Growth Areas"). However, we also expect that increasing competition in the communications industry, including the continued growth of alternative technologies such as wireless, cable and VoIP and our response to competitors' pricing strategies, as well as the trends at ATTC, will pressure revenue.

2006 Expense Trends The ATTC acquisition and related merger costs will adversely affect expenses in 2006 and 2007. We expect our operating income margin, adjusted to exclude these costs, will expand in 2008, due primarily to expected improvement in our revenues and continued cost-control measures. In particular, we expect continuing net workforce reductions over the next three years related to merger synergies and other operational initiatives. Expenses related to growth initiatives, such as Project Lightspeed (see "Expected Growth Areas"), and an expected increase in pension and other postretirement benefits costs to a range of approximately \$1,700 to \$1,800 will apply some pressure to our operating income margin.

OPERATING ENVIRONMENT OVERVIEW

In the Telecommunications Act of 1996 (Telecom Act), Congress established a pro-competitive, deregulatory national policy framework to bring the benefits of competition and investment in advanced telecommunications facilities and services to all Americans by opening all telecommunications markets to competition and reducing or eliminating burdensome regulation. Since the Telecom Act was passed, the FCC and state regulatory commissions have maintained many of the extensive regulatory requirements applicable to incumbent local exchange companies (ILECs), including our wireline subsidiaries, and imposed significant new regulatory requirements, including

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
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Dollars in millions except per share amounts

rules requiring us to unbundle our traditional network, in an effort to jump-start a specific definition of purported competition. However, over the past two years, the FCC has curtailed and, in some cases, eliminated certain of these requirements in order to promote investment and deployment of next-generation broadband services and facilities, and in response to a series of federal court decisions where the FCC's rules (in particular, those requiring ILECs to extensively unbundle their networks) exceeded the FCC's authority. For example, in February 2005, in response to a March 2004 decision by the United States Court of Appeals for the District of Columbia Circuit (D.C. Circuit), which overturned significant portions of the FCC's third set of unbundling rules, including those mandating the availability of the mass-market UNE-P, the FCC released new rules that will eliminate the requirement that our wireline subsidiaries provide the UNE-P at Total Element Long Run Incremental Cost (TELRIC) rates. Those new rules became effective March 11, 2005 and included a year-long transition for eliminating our obligation to provide mass-market UNE-P.

Additionally, on September 23, 2005, the FCC released its Title I Broadband Order (Broadband Order), which ruled that facilities-based wireline broadband internet access services offered by telephone companies are information services and should be regulated in a similar manner to broadband internet access services offered by cable companies. This order, which became effective on November 16, 2005, substantially deregulates our existing DSL services and prevents the imposition of regulation on broadband internet access services to be offered over Project Lightspeed, discussed below.

We are actively pursuing additional legislative and regulatory measures to reduce or eliminate regulatory requirements that inhibit our ability to provide the full suite of services increasingly demanded by our customers. For example, we are supporting legislative efforts at both the state and federal levels that would offer a streamlined process for new video service providers to compete with traditional cable television providers. In addition, we are supporting efforts to update regulatory treatment for retail services. As discussed in "State Regulation," Texas recently enacted legislation allowing us and other new competitors to file for a state-issued certificate of franchise authority to provide video services. The Oklahoma Corporation Commission has also issued a statewide order, which is under appeal to the Oklahoma Supreme Court by a cable provider and the AARP, that provides for increased pricing flexibility for all intrastate retail services. Other states in the 13-state area in which we operate as an ILEC are considering similar legislation. Several bills are also pending before Congress that would both reform the Telecom Act and promote additional video competition. Passage of legislation is uncertain and depends on many factors, but we believe that the increasing pace of technological change in our industry will encourage lawmakers to remove artificial barriers to competition.

Because of opportunities made available by the continued changing regulatory environment and our acquisition of ATTC, we expect that our capital expenditures in 2006 will increase to a target range of between \$8,000 and \$8,500. This amount includes capital for Project Lightspeed and

merger-integration projects (see "Project Lightspeed" discussed in "Expected Growth Areas"). Despite a slightly more positive regulatory outlook and these broadband opportunities, increasing competition and the growth of alternative technologies such as cable, wireless and VoIP have created significant challenges for our business.

Expected Growth Areas

We expect our primary wireline products, products and services offered by ATTC and wireless services to remain the most significant portion of our business and have also discussed trends affecting the segments in which we report results for these products (see "Wireline Segment Results," "AT&T Corp. Segment Results" and "Cingular Segment Results"). Over the next few years we expect an increasing percentage of our growth to come from: (1) data/broadband, through existing services, new services to be provided by our Project Lightspeed initiative and our acquisition of ATTC, and (2) Cingular's wireless service. We expect our acquisition of ATTC to strengthen the reach and sophistication of our network facilities, increase our large-business customer base and enhance the opportunity to market wireless services to that customer base. Whether, or the extent to which, growth in these areas will offset declines in other areas of our business is not known.

Our data services include DSL/Internet (broadband) as well as services to large businesses. At December 31, 2005, our data revenues represented approximately 30% of our consolidated revenues, and increased 18% from 2004. Our DSL lines continue to grow and were approximately 6.9 million at December 31, 2005 compared to 5.1 million at the end of 2004.

Project Lightspeed In June 2004, we announced key advances in developing a network capable of delivering a new generation of integrated digital television, super-high-speed broadband and VoIP services to our residential and small-business customers, referred to as Project Lightspeed. We have been building out this network in numerous locations and began providing services in one limited market, including IP video, in late 2005. Our goal in this controlled initial launch is to ensure that all operating and back-office systems function at a level capable of supporting our targeted mid-2006 scaled-up deployment. To that end, we have restricted the number of customers and services offered to the necessary minimum. Subject to successful results from this controlled launch and successful testing of our additional IP video services, we plan to enter additional markets in mid-2006. At that time we expect to add additional services and features to our service offerings. We expect to have the capability to offer service to approximately 18 million households by the end of 2008, as part of our initial deployment, and expect to spend approximately \$4,400 in network-related deployment costs and capital expenditures beginning in 2006 through 2008, as well as additional success-based customer activation capital expenditures.

With respect to our IP video service, we continue to work with our vendors to develop, in a timely manner, the requisite hardware and software technology. Our deployment plans could be delayed if we do not receive required equipment and software on schedule. We also continue to

negotiate with programming owners (e.g., movie studios and cable networks) for permission to offer existing television programs and movies and, if applicable, other new interactive services that we could offer in the future using advances in the IP technology we are testing. Our ability to provide an attractive and profitable video offering will depend in large part on the results of these efforts. Also, as discussed in the "Regulatory Developments" section, we are supporting legislation at both the federal and state levels that would streamline the regulatory process for new video competitors to enter the market.

We believe that Project Lightspeed is subject to federal oversight as a "video service" under the Federal Communications Act. Additionally, in September 2005, Texas passed a state telecommunications law that encourages new competitors to enter the video market (see "Texas Telecom Reform and Video Legislation"). However, some cable providers and municipalities have claimed that certain IP services should be treated as a traditional cable service and therefore subject to the applicable state and local regulation, which could include the requirement to pay fees to obtain local franchises for our IP video service. If the courts were to decide that state and local regulation were applicable to our Project Lightspeed services, it could have a material adverse effect on the cost, timing and extent of our deployment plans.

Wireless Cingular, our wireless joint venture with BellSouth, began operations in October 2000. In October 2004, Cingular completed its acquisition of AT&T Wireless, which established Cingular as the largest provider of mobile wireless voice and data communications services in the U.S. At December 31, 2005, Cingular served approximately 54.1 million customers and had access to licenses to provide wireless communications services covering an aggregate population of potential customers of approximately 294 million, or approximately 99% of the U.S. population, including all of the 100 largest U.S. metropolitan areas.

Cingular's wireless networks use equipment with digital transmission technologies known as GSM and TDMA technology. Cingular has upgraded its existing TDMA markets to use GSM technology in order to provide a common voice standard. Cingular is also adding high-speed wireless data services such as General Packet Radio Service (GPRS) and Enhanced Data Rates for Global Evolution (EDGE) and Universal Mobile Telecommunications System (UMTS). EDGE technology allows customers to access the Internet from their wireless devices at higher speeds than GPRS and UMTS allows for superior speed for data and video services.

We expect that intense industry competition and market saturation will likely cause the wireless industry's customer growth rate to moderate in comparison with historical growth rates. While the wireless telecommunications industry does continue to grow, a high degree of competition exists among four national carriers, their affiliates and smaller regional carriers. This competition will continue to put pressure upon pricing, margins and customer turnover as the carriers compete for potential customers. Future carrier revenue growth is highly dependent upon the number of net customer additions a carrier can achieve and the average revenue per customer. The effective management

of customer turnover, or churn, is also important in minimizing customer acquisition costs and maintaining and improving margins.

Cingular faces many challenges and opportunities in the future and is focused on the following key initiatives:

- Further establishing its position as a premier provider for business and government accounts by providing these customers with access to sales and support professionals focused solely on their specialized needs.
- Continued improvement on the coverage and quality of its network. Cingular continues its process of completing the integration of the Cingular and AT&T Wireless networks under a plan that is designed to achieve network quality and coverage performance exceeding that of either of the former networks.
- Continued deployment of UMTS third-generation (3G) network technology with High-Speed Downlink Packet Access (HSDPA). UMTS and HSDPA provide superior speeds for data and video services, as well as operating efficiencies using the same spectrum and infrastructure for voice and data on an IP-based platform and will allow Cingular to offer a host of new broadband data applications.

REGULATORY DEVELOPMENTS

Set forth below is a summary of the most significant developments in our regulatory environment during 2005. While these issues, for the most part, apply only to certain subsidiaries in our wireline segment or AT&T Corp. segment, the words "we," "AT&T," "ATTC" and "our" are used to simplify the discussion. The following discussions are intended as a condensed summary of the issues rather than a precise legal description of all of those specific issues.

International Regulation ATTC subsidiaries operating outside the U.S. are subject to the jurisdiction of national regulatory authorities in the market where service is provided. Regulation is generally limited to operational licensing authority for the provision of enterprise (i.e. large business) services.

Federal Regulation A summary of significant 2005 federal regulatory developments follows.

Triennial Review Remand Order In December 2004, the FCC adopted its fourth set of rules concerning an ILEC's obligation to make elements of its network available to other local service providers. Each of its previous three sets of rules had been overturned by the federal courts. On February 4, 2005, the FCC released its written order containing the new rules, the Triennial Review Remand Order (TRRO) which became effective on March 11, 2005. The TRRO provides significant relief from unbundling by eliminating our remaining obligation to provide local switching and hence the UNE-P, for mass-market customers, subject to a 12-month transition period. At December 31, 2005, we had approximately 500,000 remaining UNE-P lines subject to the March 2006 transition deadline. Based on our marketing research, we believe that the majority of customers of those competitors who have not signed commercial UNE-P replacements or resale agreements with us have switched to alternative technologies as opposed to returning as our retail customers.

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Dollars in millions except per share amounts

Changes in available technology could increase competition and our capital costs.

The telecommunications industry has experienced rapid changes in the last several years. The development of wireless, cable and IP technologies has significantly increased the commercial viability of alternatives to traditional wireline telephone service. In order to remain competitive, we have begun to deploy a more sophisticated network and continue to research other new technologies. If the new technologies we have adopted or on which we have focused our research efforts fail to be cost-effective and accepted by customers, our ability to remain competitive could be materially adversely affected.

Changes to federal and state regulations and decisions in regulatory proceedings could materially adversely affect us.

Our wireline and ATTC subsidiaries are subject to significant federal and state regulation while many of our competitors are not. The adoption of new regulations or changes to existing regulations could significantly increase our costs which either would reduce our operating margins or potentially increase customer turnover should we attempt to increase prices to cover our increased costs. In addition, the development of new technologies, such as IP-based services, has created or potentially could create conflicting regulation between the FCC and various state and local authorities, which may involve lengthy litigation to resolve and may result in outcomes unfavorable to us.

Increasing competition in our wireline markets could adversely affect wireline operating margins.

We expect competition in the telecommunications industry to continue to intensify. We expect this competition will continue to put pressure on pricing, margins and customer retention. A number of our competitors that rely on alternative technologies (e.g., wireless, cable and VoIP) are typically subject to less (or no) regulation than our wireline and ATTC subsidiaries and therefore are able to operate with lower costs. These competitors also have cost advantages compared to us, due in part to a non-unionized workforce, lower employee benefits and fewer retirees (as most of the competitors are relatively new companies). We believe such advantages can be offset by continuing to increase the efficiency of our operating systems and improving employee training and productivity but there can be no assurance our efforts in these areas will be successful.

Increasing competition in the wireless industry could adversely affect Cingular's operating results.

On average, Cingular has three to four other wireless competitors in each of its service areas and competes for customers based principally on price, service offerings, call quality, coverage area and customer service. In addition, Cingular is likely to experience growing competition from providers offering services using alternative wireless technologies and IP-based networks as well as traditional wireline networks. Cingular expects intense industry

competition and market saturation likely will cause the wireless industry's customer growth rate to moderate in comparison with historical growth rates. This competition will continue to put pressure on pricing, margins and customer turnover as companies compete for potential customers. Cingular's ability to respond will depend, among other things, on improving customer retention and reducing customer turnover by subsidizing product upgrades and/or reducing pricing to match competitors' initiatives, upgrading Cingular's network and providing improved customer service. These efforts will involve significant expenses and require strategic management decisions on matters such as technology choices, marketing plans and financial budgets. We and BellSouth provide Cingular with its working capital financing; if we or BellSouth were unable or unwilling to finance Cingular's operating and capital needs on a timely basis or permit third-party financing, Cingular would be unable to pursue its business plan. Since we jointly manage Cingular with BellSouth, if we and BellSouth cannot agree, inaction or disputes may result, which could have a material adverse effect on Cingular's operating results.

The success of our Project Lightspeed broadband initiative will depend on the timing, extent and cost of deployment, the development of attractive and profitable service offerings and the extent to which regulatory, franchise fees and build-out requirements apply to this initiative.

The trend in telecommunications technology is to shift from the traditional circuit and wire-based technology to Internet Protocol-based technology. IP-based technology can transport voice and data, as well as video, from both wired and wireless networks. IP-based networks also potentially cost less to operate than traditional networks. Our competitors, many of which are newer companies, are deploying this IP-based technology. In order to continue to offer attractive and competitively-priced services, we are deploying a new broadband network to offer IP-based voice, data and video services. Using a new and sophisticated technology on a very large scale entails risks but also presents opportunities to expand service offerings to customers. Should deployment of our network be delayed or costs exceed expected amounts, our margins would be adversely affected and such effects could be material. Should regulatory requirements be different than we anticipated, our deployment could be delayed, perhaps significantly, or limited to only those geographical areas where regulation is not burdensome. In addition, should the delivery of services expected to be deployed on our network be delayed due to technological or regulatory constraints or other reasons, or the cost of providing such services becomes higher than expected, customers may decide to purchase services from our competitors which would adversely affect our revenues and margins, and such effects could be material.

Our acquisition of ATTC may not be integrated successfully; the expected cost savings and any other synergies from the acquisition may take longer to realize than expected or may not be fully realized; and disruption from the acquisition may adversely affect our relationships with customers, employees, suppliers and other parties.

We acquired ATTC in order to combine ATTC's global systems capabilities, business and government customers and IP-based business with our local exchange, broadband and wireless services and to create potential cost savings, revenue synergies, technological development and other benefits. Achieving these results will depend in part on successfully combining two large corporations, which could involve significant management attention and create uncertainties for employees. Diversion of attention from ongoing operations on the part of management and employees could adversely affect our customers, suppliers and other parties with whom we have relationships. We also expect to incur substantial expenses related to the integration of ATTC. We must integrate a large number of systems, both operational and administrative. These integration expenses will likely result/have resulted in our taking significant charges against earnings, both cash and noncash, primarily from the amortization of intangibles and one-time impairments. Delays in this process could have a material adverse effect on our revenues, expenses, operating results and financial condition. In addition, events outside of our control, including changes in state and federal regulation and laws as well as economic trends, also could adversely affect our ability to integrate ATTC and such effects may be material.

Cingular's acquisition of AT&T Wireless may not be integrated successfully; the expected costs savings and any other synergies from the acquisition may take longer to realize than expected or may not be fully realized; and disruption from the acquisition may adversely affect our relationships with customers, employees, suppliers and other parties.

Cingular acquired AT&T Wireless to add additional spectrum and expand its network coverage and enhance its business customer base. By adding size and scale, Cingular expects to compete more effectively in the wireless industry and procure more significant cost economies from vendors. In order to achieve these goals, Cingular must integrate separate network systems and consolidate other operating and support systems without reducing network service coverage or quality or customer service. Cingular also must develop and offer competitive and attractive services. If Cingular does not accomplish its integration plan in a timely and cost-effective manner, Cingular may lose customers, experience reduced growth and fail to realize the anticipated benefits and synergies of the acquisition to the extent, or in the time frame, expected.

expense over the term of the interest payments of the related debt issuances.

Changes in the fair value of undesignated derivatives are recorded in other income (expense), net, along with the change in fair value of the underlying asset or liability, as applicable.

Cash flows associated with derivative instruments are presented in the same category on the Consolidated Statements of Cash Flows as the item being hedged.

When hedge accounting is discontinued, the derivative is adjusted for changes in fair value through other income (expense), net. For fair value hedges, the underlying asset or liability will no longer be adjusted for changes in fair value and any asset or liability recorded in connection with the hedging relationship (including firm commitments) will be removed from the balance sheet and recorded in current period earnings. For cash flow hedges, gains and losses that were accumulated in other comprehensive income as a component of Stockholders' Equity in connection with hedged assets or liabilities or forecasted transactions will be recognized in other income (expense), net, in the same period the hedged item affects earnings.

Employee Separations In accordance with Statement of Financial Accounting Standards No. 112, "Employers' Accounting for Postemployment Benefits," we establish obligations for expected termination benefits provided to former or inactive employees after employment but before retirement. These benefits include severance payments, workers' compensation, disability, medical continuation coverage and other benefits. At December 31, 2005, we had severance accruals for legacy SBC employees of approximately \$410, of which \$283 was established as merger-related severance accruals. In accordance with Statement of Financial Accounting Standards No. 141, "Business Combinations" (FAS 141), severance accruals recorded for ATTC employees were included in the purchase price allocation (see Note 2). At December 31, 2004, we had severance accruals of approximately \$147.

Pension and Postretirement Benefits See Note 10 for a comprehensive discussion of our pension and postretirement benefit expense, including a discussion of the actuarial assumptions.

NOTE 2. ACQUISITIONS AND DISPOSITIONS

Acquisitions

AT&T Corp. In November 2005, we acquired ATTC in a transaction accounted for under FAS 141. ATTC was one of the nation's largest business service communications providers, offering a variety of global communications services, including large domestic and multinational businesses, small and medium-sized businesses and government agencies. ATTC operated one of the largest telecommunications networks in the U.S. with enterprise networking services available in 127 countries at December 31, 2005. ATTC was also a provider of domestic and international long-distance and usage-based-communications services to consumer customers.

Under the merger agreement, each share of ATTC common stock was exchanged for 0.77942 of a share of our common stock. We issued approximately 632 million shares to ATTC shareholders, giving them an approximate 16 percent stake in the combined company, based on common shares outstanding. In addition, immediately prior to the closing of the transaction, ATTC paid each ATTC shareholder a special dividend of \$1.30 per share. Based on the \$24.17 per share closing price of our common stock on the New York Stock Exchange (NYSE) on November 17, 2005, the last trading day before the closing of the merger, combined with the special dividend, consideration received by ATTC shareholders was approximately \$16,300.

Based on the average closing price of our common stock on the NYSE for the two days prior to, including, and two days subsequent to the public announcement of the merger (January 31, 2005) of \$23.87 and capitalized merger-transaction costs, the transaction was valued, for accounting purposes, at approximately \$15,517. ATTC is now a wholly owned subsidiary of AT&T and the results of ATTC's operations have been included in our consolidated financial statements after the November 18, 2005 acquisition date.

We paid a premium (i.e., goodwill) over the fair value of the net tangible and identified intangible assets acquired for a number of reasons, including the following:

Strategic Fit

- Our company will benefit from ATTC's assets and capabilities, including: a state-of-the-art nationwide and global communications network; advanced technological capabilities in data and internet protocol (IP)-based services; sales and service expertise for complex communications services; and significant product and service development capabilities in AT&T Labs, a leading communications research organization.
- The merger will combine our broad consumer and small- and medium-business customer base with ATTC's enterprise and government customer bases.
- The combined company will have a strong, diversified set of products and service offerings.

Cost Savings and Revenue Synergies

- Combined network operations and IT expenses will decrease, as facilities and operations will be consolidated.
- Sales and support functions of the business services organizations will be combined.
- Duplicate corporate functions will be eliminated.

Technological Strength

- In acquiring ATTC's assets, which include an advanced product portfolio as well as a leading communications research organization (AT&T Labs), we will now have additional resources and skills to innovate and more quickly deliver to customers the next generation of advanced, integrated IP-based wireline and wireless communications services.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Dollars in millions except per share amounts

The application of purchase accounting under FAS 141 requires that the total purchase price be allocated to the fair value of assets acquired and liabilities assumed based on their fair values at the acquisition date, with amounts exceeding the fair values being recorded as goodwill. The allocation process requires an analysis of acquired fixed assets, contracts, customer lists and relationships, contractual commitments, legal contingencies and brand value to identify and record the fair value of all assets acquired and liabilities assumed. In valuing acquired assets and assumed liabilities, fair values were based on, but not limited to: future expected discounted cash flows for trade names and customer relationships; current replacement cost for similar capacity and obsolescence for certain fixed assets; comparable market rates for contractual obligations and certain investments, real estate and liabilities, including pension and postretirement benefits; expected settlement amounts for litigation and contingencies, including the AT&T Wireless litigation, and; appropriate discount rates and growth rates.

Under the purchase method of accounting, the assets and liabilities of ATTC were recorded at their respective fair values as of the date of the acquisition, November 18, 2005, and we recorded goodwill of \$12,343. We have obtained preliminary third-party valuations of property, plant and equipment, intangible assets (including the AT&T trade name), debt and certain other assets and liabilities. Because of the proximity of this transaction to year end, the values of certain assets and liabilities are based on preliminary valuations and are subject to adjustment as additional information is obtained. Such additional information includes, but is not limited to: valuations and physical counts of property, plant and equipment, valuation of investments and the involuntary termination of employees. We will have 12 months from the closing of the acquisition to finalize our valuations. Changes to the valuation of property, plant and equipment may result in adjustments to the fair value of certain identifiable intangible assets acquired. When finalized, material adjustments to goodwill may result.

We have not identified any material unrecorded pre-acquisition contingencies where the related asset, liability or impairment is probable and the amount can be reasonably estimated. Prior to the end of the one-year purchase price allocation period, if information becomes available which would indicate it is probable that such events had occurred and the amounts can be reasonably estimated, such items will be included in the final purchase price allocation and may adjust goodwill.

The following table summarizes the preliminary estimated fair values of the ATTC assets acquired and liabilities assumed and related deferred income taxes as of acquisition date.

	ATTC
Assets acquired	
Current assets	\$ 6,295
Property, plant and equipment	10,921
Intangible assets not subject to amortization	
Trade name	4,900
Licenses	40
Intangible assets subject to amortization	
Customer lists and relationships	3,050
Patents	150
Brand licensing agreements	70
Investments in unconsolidated subsidiaries	160
Other assets	4,247
Goodwill	12,343
Total assets acquired	42,176
Liabilities assumed	
Current liabilities, excluding	
current portion of long-term debt	6,740
Long-term debt	8,293
Deferred income taxes	531
Postemployment benefit obligation	8,807
Other noncurrent liabilities	2,288
Total liabilities assumed	26,659
Net assets acquired	\$15,517

Goodwill of \$12,343, resulting from the acquisition of ATTC was assigned to the AT&T Corp. segment. However, as part of the final valuation of the acquisition we will determine to which entities and to what extent the benefit of the acquisition applies, and as required by GAAP record the appropriate goodwill to each entity. Goodwill includes a portion of value for assembled workforce which is not separately classified from goodwill in accordance with FAS 141. The purchased intangibles and goodwill are not deductible for tax purposes. However, purchase accounting allows for the establishment of deferred tax liabilities on purchased intangibles (other than goodwill) that will be reflected as a tax benefit on our future Consolidated Statements of Income in proportion to and over the amortization period of the related intangible asset.

Substantially all of the licenses acquired and the trade name of AT&T have an indefinite life, and accordingly, are not subject to amortization. The customer relationships intangible assets are being amortized over a weighted period of 1.5 to 9 years for business customers and 1.5 to 2.5 years for consumer customers, using the sum of the months digits method of amortization. This method best reflects the estimated pattern in which the economic benefits will be consumed. Patent intangible assets include protective and commercialized patents, which are amortized using the straight-line method over 2 to 18 years based on the remaining lives of the patents and have a weighted-average amortization period of 10 years.